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The Invisible Hand: Financial Pressure and Organizational Convergence in Multilateral Development Banks

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Abstract

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Key words: Multilateral, development, World Bank, Inter-American Development Bank, Andean Development Corporation, aid

Introduction

The first multilateral development bank (MDB) was created in 1944 with the founding of the World Bank, and they have since proliferated across the globe. According to one count, some 20 MDBs currently operate in some or all parts of the world, and—if the plans of the BRICS nations come to fruition[1]—another will likely soon be created. Considering this track record, one can safely say that this specialized model of international organization has proved to be well suited to the needs of governments in the global political and economic context of the past 70-odd years, and remains so today.

The members of this particular "family" of organizations differ in a number of ways—technical assistance capacity, types of loans and operational rules, degree of grants vs. loans—but have many important traits in common.[2] Most obviously, they are all owned by governments and predominantly lend to governments for the purposes of development, broadly defined. But perhaps the one trait that goes farthest in explaining their success as an organizational model is that they are mainly self-financing: MDBs borrow most of their money on international capital markets, and then on-lend these resources at terms better than recipient countries could generally get themselves in the markets, with enough of a margin left over to cover MDB administrative costs. Thus, regular operations imply no direct budgetary cost to shareholder governments, apart from relatively minimal capitalization costs,[3] and MDBs (arguably) generate the public good of development promotion, as well as potential geo-political benefits to powerful shareholders, as

[1] Financial Times, 2013.
[2] For one definition see IDS, 2000: 4.
[3] Much of which is actually in callable, guarantee capital, rather than cash. For example, of the World Bank's US$205.4 billion in capital, only US$12.4 billion (6%) is paid in by 188 member countries, while the remainder (94%) is guaranteed.

highlighted by numerous researchers including Mohammed, 2004; Dreher et al., 2009; Gilbert et al., 1999; Harrigan et al., 2006; and Kapur, 2002, to name just a few.

How did this mechanism of utilizing bond markets come to be the standard financial model for MDBs, rather than direct transfers from member governments as in many other international organizations? The answer is relatively straightforward: MDBs require considerable levels of resources if they are to fulfill their development mission, and the generosity of most shareholder governments is limited, especially in funding a multilateral organization over which they do not have complete control. Powerful countries may be willing to offer their backing to MDB bonds, and even make some contributions for concessional loans to the poorest countries, but they have scant interest in coming up with significant volumes of money for regular MDB operations. Accessing private financial markets is therefore the only realistic alternative if an MDB is to survive as a viable international organization capable of undertaking significant development operations.

Relying on international capital markets rather than fiscal allocations give MDBs a degree of financial security and independence from the fickle generosity of shareholder countries, but this comes with a cost. As recent events in several southern European nations have shown, bond markets are extraordinarily unsympathetic to those who do not perform as they demand. Not for nothing did the U.S. political consultant guru James Carville once comment that if reincarnation existed, “I want to come back as the bond market. You can intimidate everybody” (Wall Street Journal 1993: A1).

The historical record shows that using capital markets as the key source of financing had a fundamentally important impact on the way each of the three MDBs considered in this article—the World Bank, the Inter-American Development Bank (IADB) and the Andean Development Corporation (CAF)—were run. In each case, financial imperatives and pressures exerted by private capital markets partly undermined the original conceptions of MDB founders, leading each MDB to move in unexpected directions as a result. The use of capital markets for financing was in itself not a shock to founding members, and was in fact expected as a basic element of all three MDBs' financial models (although in each case not to the degree that would eventually be the case). What founders did not foresee was how this external source of financing would shape the way the MDBs sought to fulfill their mandates, as well as their membership structure.

The lessons of organizational sociology suggest that when an organization is faced with a conflict between maintaining rigid adherence to its original mission and securing the resources needed to survive, the former is frequently sacrificed to the latter. Pfeffer and Salancik (1978) note that almost all organizations, both public and private, depend for survival on resources over which they have only limited control, be it paying clients, budgetary allocations or, in the case of MDBs, bond buyers.[4] Expanding on this idea with specific reference to international organizations, Barnett and Coleman (2005) conceive of IOs as strategic actors dealing with a complex external environment, and reacting in ways that ensure access to essential external resources: "The more dependent they are on others, the more likely IOs will alter their activities

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[4] The MDB model also requires a steady stream of countries willing to borrow from them. This was a minimal issue during the time period considered here (demand for loans far outstripped supply), but is now a much more important issue for many MDBs in light of the growing financial strength of many middle-income countries. See Humphrey and Michaelowa, 2013.

in a way that conforms to these external demands and standards." (Barnett and Coleman 2005: 599).

At the same time, the authors recognize the importance of constructivist concepts such as professional self-image and institutional culture, and posit these as limitations on how far an organization will bend itself in pursuit of resources—a limitation not considered by more rationalist public-choice oriented scholars: "…because conformity might come at a cost to their autonomy and ability to pursue their mandate as they define it, IO staff will be attentive to the autonomy-resource trade-off." (Barnett and Coleman 2005: 595). The authors explore how Interpol initially resisted moving into the area of terrorism because of concerns about becoming enmeshed in politics and giving up autonomy, despite potentially greater resources, and the organization's eventual acquiescence in the face of competition and resource strain.

The trade-off between resources and organizational autonomy from political influence takes on a different character in the particular case of MDBs, because of their use of capital markets as opposed to the budgetary allocations. In a sense, this is not a simple continuum of giving up more or less autonomy in exchange for resources, as Barnett and Coleman suggest, but rather losing a degree of autonomy to one kind of external authority (bond markets) instead of another (member states).

The question then arises as to whether the dependence of MDBs on financial markets, and the constraints it implied, clashed with i) the aims of powerful shareholding (that is, realist views of international organizations) and/or ii) the organizational culture and professional self-image of staff (that is, more constructivist views). The evidence reviewed here indicates that reliance on bond markets strongly suited the interests of powerful shareholders, as it limited their fiscal contributions, and the exigencies that this model engendered did not threaten the overall aims of these shareholders for the MDBs. At the same time, the fact that MDBs can raise the resources needed to operate by issuing bonds means that shareholders have less direct "power of the purse" over the MDB. This, in turn, has afforded MDBs considerably more operational autonomy from shareholders than might otherwise be the case, in part fueling the tensions between shareholders and staff explored by many scholars using principal-agent frameworks (for example, Gutner 2005 and Hawkins, et al. 2006).

Evidence from the three case studies also suggests that each MDB's organizational culture was strongly shaped by the requirements of obtaining necessary resources. In all three cases, the MDBs shifted away from certain types of development practices and membership structures in ways that clearly obeyed the necessities of securing financing from capital markets. It may well be that staff resisted these changes—this paper does not explore the issue—but in the end the changes occurred and the resources were secured. Chwieroth (2008) examines some of the same issues considered here in relation to the early history of the World Bank, and concludes that this is a case of "change from within" driven by normative entrepreneurship on the part of key staff members. The current research parallels Chwieroth's piece very closely in many respects, but finds evidence to suggest that the change was the result of external rather than internal pressures, as will be discussed in more detail in the next section.

A key reason why these MDBs were able to shift away from the original conceptions of their founders and reshape the internal culture to suit the needs of resource acquisition was the nature of their mandate. As Babb (2003) points out in her analysis of the IMF in the 1970s, the organizational mandate of IOs is uniquely ambiguous, resulting from complex international negotiations that necessitate a healthy degree of vagueness to reach a final agreement among competing interests. This ambiguity, Babb suggests, allows IOs a particularly high degree of room to maneuver in redefining their mandates as needed for survival. In the case of MDBs, the goal of promoting development is especially ambiguous, not just in how one should best pursue it but even in defining exactly what constitutes "development" in the first place—both topics that are the subject of intense and continuous debate. This proved extremely useful as MDBs faced the realities of endearing themselves bond markets while at the same time claiming to successfully fulfill their mandate.

This paper examines how each of the three MDBs changed their operations and even (in the case of the IADB and CAF) their membership structure in response to the requirements of international capital markets to ensure their survival. What is more, the research reveals that changes in each MDB all pointed in a similar direction, converging on a model of MDB activity much closer to one another than their founders had intended. Thus, if one presupposes: i) the limited willingness of governments to provide budgetary resources to MDBs and ii) a built-in desire for organizational survival, then there seems to be almost an "ideal type" of MDB, toward which all will tend to evolve.

The following three sections consider how the World Bank, IADB and CAF each grappled with the problem of securing the resources they needed to survive and grow, and how this directly impacted their operations. The periods to be examined are the World Bank 1947-1963, the IADB 1960-1975 and the CAF 1970-1993. In each case this encompasses the early phase of organizational life cycle: conception, birth and adolescence. Each case concludes with a turning point that deeply shaped the MDBs we see today—their "mature" form.

The World Bank: From New Deal to Wall Street and Part Way Back Again

The idea of a multilateral development bank began at least as early as 1890, when a number of Latin American countries pushed for the creation of a specialized bank to facilitate capital flows to their region (Kapur, et al., 1997). In 1942, a U.S. Treasury team under the leadership Harry Dexter White, who had worked on an earlier, abortive inter-American bank proposal (U.S. Department of State, 1940; Helleiner, 2006 and 2009), took up the ideas again during the Bretton Woods conference when designing the International Bank for Reconstruction and Development (IBRD)—more commonly known as the World Bank—to facilitating credit flows for reconstruction after the war. All member countries agreed to pay in a determined amount of cash and gold (20%), and guarantee the bank's remaining capital subscription to be called on if necessary to meet its obligations. The bank would be governed by country shareholders with voting power directly proportional to their contributions—just as a private corporation. Perhaps not coincidentally, this scheme afforded the U.S. a dominant voice in controlling the Bank.

The Roosevelt and subsequent Truman administrations viewed the newly created World Bank primarily as a tool of government, not Wall Street. This was manifested in locating it in Washington DC, over the objections of several European countries, who favored New York. As Treasury Secretary Fred Vinson wrote at the time, referring to the World Bank and IMF, "They are cooperative enterprises of governments and their chief business is with governments…They should not become just two more financial institutions" (1946: 626). The U.S. intended to keep a tight reign over the Bank's administrators by making them subservient to a board of executive directors representing member countries, which would sit in permanent session and vote on all decisions. Again, Vinson explained the logic: "If final authority is vested in the administrative officials, the Executive Directors become little more than an advisory body. In my opinion, this would be contrary to the manner in which it was intended to operate the Fund and the Bank" (Ibid.: 627).

It was generally assumed at Bretton Woods that the World Bank would primarily offer guarantees for governments borrowing from private sources, rather then lending directly. However, both New York investors and the new Bank management were unenthusiastic about guarantees, for a number of practical reasons (Mason and Asher, 1973).[5] But if the Bank would be making loans rather than guarantees, it faced a serious shortage of capital. The only lendable resources available to the Bank at its launch were the U.S. paid-in capital and the 2% paid in gold by other members—a total of US$727 million.[6] This paled in comparison to the

[5] Even with a guarantee, many countries would still be paying considerably more for money then if the Bank borrowed itself and lent it on, which didn't make sense. As well, regardless of the guarantee, the markets would offer differing interest rates to different clients, which the IBRD feared could impact its own credit rating.
[6] This was due to the insistence of the British at Bretton Woods—led by J. M. Keynes—that the member currency portion of paid-in capital would only be used for lending with the explicit consent of the country (Bittermann, 1971). Thus only the 2% of capital paid in convertible currencies for all countries (except the U.S., which contributed the full 20% in convertible currency) could be used for lending.

reconstruction needs of post-war Europe. Just the first two loan applications alone, from France and Netherlands, totaled US$1.035 billion. As a result, turning to the markets was a clear necessity right from the start, as noted at the time by The Economist: "The French loan alone obviously earmarks a substantial portion of the total stock of dollars. Hence the Bank must soon determine its ability to obtain more dollars, which of course can only be done by borrowing in the American market…Consequently, extensive explorations are under way with the market" (1947b: 760).

As it became increasingly clear that the bank would need a strong relationship with the markets, the early leaders were recruited from Wall Street. John J. McCloy, a lawyer with strong connections to the New York financial community, was persuaded to accept the presidency in late 1946.[7] Before doing so, McCloy set as his conditions that the board make a clear statement ensuring that management would be allowed a generally free hand in running operations, and the board would confine itself to a supervisory role—directly against the model described by Vinson above. His reasoning was that the markets would simply not trust the bonds of an institution governed on a day-to-day basis by politicians. The Bank's executive directors resisted, but faced with McCloy's threat to walk out immediately, they backed down (WBOH 1961a: 4). Thus right at the start of its operations, in the interests of establishing a "serious" financial institution free from political meddling, McCloy ensured a far greater degree of staff autonomy from the political influence of executive directors than originally envisioned at Bretton Woods. McCloy brought with him Robert Garner to serve as his vice-president, a hard-nosed New York banker, and U.S. executive director Eugene Black, former vice-president of Chase National Bank of New York. The Economist magazine noted with satisfaction that the new leadership were "nominees

[7] The first president was Eugene Meyer, who resigned after only a few months on the job.

of Wall Street" (1947a: 638). Black himself, in a later interview, made clear his view on the importance of non-political leadership of the Bank in the eyes of the bond markets: "…if they tried to put some politician in there [Bank leadership], nobody would buy the bonds. They wouldn't have any money" (WBOH 1961b: 53).

Despite the Wall Street-friendly management, private financial markets had every reason to be wary of lending to this unknown new financial creature, which was specifically designed to lend to foreign countries, many of them poor and with a long history of defaults—hardly a business model to gain Wall Street's trust. Thus the initial forays of World Bank staff to New York were not a resounding success. Recounting his first trip to meet investment bankers in New York, one staffer said, "There was an amazing discrepancy between the attitude of the bankers and the expectations of Bretton Woods …In general, it was thought of as a do-good institution, as a wild idea, without any respectable support" (WBOH 1961c: 10-11). Winning over the financial community became the primary objective of the new bank's staff—without the trust of the markets, it could not survive.

The intensive preparatory work of the Bank leadership, as well as their personal contacts and good reputation on Wall Street, paid off when the Bank's first two bonds were publicly issued on July 15, 1947, for US$250 million—the exact amount of the Bank's first loan, just issued to France (Mason and Asher, 1973). Despite this success, future prospects for regular bond issues were far from certain. The following year, an article in The Economist noted that "Since [Bank's] dollar resources cannot be allowed to run down completely, the remaining scope for dollar loans is modest and will remain so unless Wall Street can be induced to absorb another issue of the IBRD's bonds. There is very little prospect of this at the moment" (1948: 502). The Bank would not issue again in the New York market until 1950. Establishing a regular presence as a borrower would take more than good marketing—it would require demonstrating that the Bank would operate in a way that made it a safe investment. This, in turn, would fundamentally shape the Bank's lending.

Wall Street Concerns Shape Early Operating Policies

McCloy's team made no bones at all about the principles that guided early lending operations. In presenting the second annual report to the Board of Directors in September 1947, McCloy stated that "the Bank must attach importance to the views of the American investor and must conduct its activities in such a fashion that its bonds will be considered a sound business risk by the United States financial community" (Mason and Asher 1973: 54). A few years later Garner—who was in charge of operations at the time—stated that "The Bank must convince the private investors who buy its bonds that it is operating on sound banking principles. Otherwise, we might be cut off from one of our main sources of funds for lending" (World Bank, 1952).

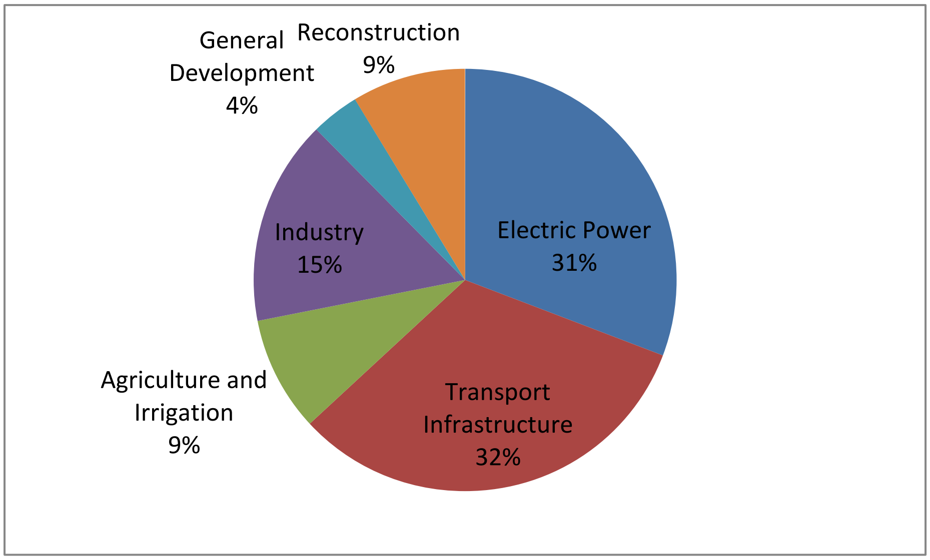
In the three years between Bretton Woods and the Bank's first loan to France in May 1947, U.S. policymakers drew up the Marshall Plan for European reconstruction. This removed what had been the Bank's initial purpose—post-war reconstruction—and also removed what would have been its most creditworthy borrowers. Thus the Bank was quickly pushed into the unknown territory of "development." Between August 1947 and the end of 1949, the Bank made only three loans, two to Chile for US$28 million and one to the Netherlands for US$12 million. This was driven by the inability to raise more money on the market, and also by the desire to establish exacting technical standards for loan approval that would be seen as prudent by potential bond investors. “We had then to show that we were going to make some sound loans, that we were not going to give the money away. Until we did that and until we acquainted people with what the other safeguards were, the Bank had no credit,” said Black, reflecting on this period (WBOH 1961b: 7).

A key aspect of how the Bank established and guarded its credit standing with the markets was the kind of loans it made. The Articles of Agreement call for lending only for “specific projects”, although (with characteristic vagueness) this could be bypassed in “special circumstances.” The specific project ethos became an obsession with the early Bank.[8] One of the great advantages of the specific project, as one early staffer openly admitted, was that it looked good to the markets. “The market likes the idea of specific projects,” said one. “There's a feeling that if you know exactly where the money goes, it must be a sound thing” (WBOH 1961d: 41). The Bank focused on projects that would generate income, and hence increase its chances of getting repaid. This meant physical infrastructure with direct economic impacts. “I think that if we got into the social field in the Bank then the bond market would definitely feel that we were not acting prudently from a financial standpoint,” said one early staffer. “If you start financing schools and hospitals and water works, and so forth, these things don't normally and directly increase the ability of a country to repay a borrowing” (WBOH 1961e: 63-4).[9] This led to a very heavy emphasis on

[8] This is despite the fact that the almost complete fungibility of money in a borrowing government’s accounts made the “specific project” a myth. See, for example, Feyzioglu et al. (1998). For a detailed examination of the project culture in the Bank’s early years, see Chwieroth (2008)
[9] The avoidance of socially-oriented loans in the early World Bank is discussed in Alacevich, 2009.

electric power, transportation infrastructure and large-scale irrigation works, which were seen as sound, bankable projects (Fig. 1).

Figure 1. IBRD Lending by Sector, 1947-61



Source: World Bank annual reports 1947-1961.

Hand in hand with the specific project lending style, the Bank also evolved a rigorous and intrusive system of resource disbursement. In choosing which countries to lend to, the issue of need or income level played a minimal role, while a country's perceived credit risk was a major factor. "The general idea was quite clear even at that early stage that the Bank could lend only if it were satisfied that it could get its money back. Therefore, a study of the economy of the country was pretty fundamental," said an early staffer (WBOH 1961d: 5). Thus, the Bank's extreme intrusiveness into domestic economic policy began right from the start, specifically to reassure its bond buyers that it was keeping a close eye on its resources.

As well, lending was slanted heavily toward more creditworthy borrowers, rather than poorer countries. Out of US$5.7 billion in Bank loan commitments between 1947 and 1961, US$2.6 billion (45%) went to Europe or Australia and a further US$1.4 billion (25%) to larger and more advanced developing countries.[10] Only US$1.7 billion (30%) was dedicated to poorer developing countries, of which nearly US$1 billion went to India and Pakistan— countries of key geopolitical interest to the U.S. and the U.K., the Bank's two most powerful shareholders at the time.[11] Hence, poverty considerations appear to have been a low priority in directing where the Bank lent its money.

An Embarrassment of Riches and the Birth of IDA

As a result of the operational policies described above, the World Bank reputation as a "sound" financial institution grew. The spread between Bank and U.S. government bonds of similar maturities fell from 0.74% in 1947 to 0.25% in 1952 (Mason and Asher, 1973), and the Bank began accessing capital markets outside of the U.S. However, the Bank's increasingly solid financial situation and excellent reputation in the credit markets had no impact on the tough conditions for borrowers. As early as 1950, even The Economist was calling for it to relax: "Recent experience has shown that its rigid approach and conditions of lending (for which there is something to be said on other grounds) do not provide a flexible means of handling the infinite variety of projects that must emerge from any programme for the opening up of under-developed

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[10] This includes: Argentina, Brazil, Chile, Colombia, Costa Rica, Iran, Israel, Mexico, South Africa and Uruguay.
[11] This includes: Burma, Ceylon, Ecuador, Egypt, El Salvador, Ethiopia, Guatemala, Haiti, Honduras, India, Iraq, Lebanon, Nicaragua, Pakistan, Panama, Paraguay, Peru, Philippines, Sudan, and Thailand.

countries. It resembles commercial banks in the United States in that it is too intent on the collateral or security aspect of any operation" (1950: 546).

But Bank leadership fended off calls for change, invariably pointing to the fickle opinion of the all-important bond market. There was some justification for this position in light of the Bank's long-running battle to receive the coveted AAA rating by the ratings agencies, which was finally granted in 1959. Other evidence, however, suggests that while the Bank's operating style may have been a necessity to access resources in the first years, it had simply become ingrained behavior by the end of the 1950s. One high-level staffer noted that by 1961, bond holders no longer "scrutinize the day-to-day lending operations the way they used to," adding that if the Bank wanted to start lending for things like water distribution, "I don't think these things would have the slightest affect on its credit" (WBOH 1961f: 65). But preoccupation with bond buyers had planted deep roots in the Bank's organizational culture, as analyzed incisively by Chwieroth (2008).

By the end of the 1950s the Bank's net income increased each year and reserves grew from US$4 million in 1948 to US$288 million in 1964. As a result, the Bank faced rising criticism to ease the terms of its loans and to ramp up lending to address development concerns. A 1951 United Nations report, calling for billions more to be lent annually for development, states that "In view of the need of under-developed countries for capital, the Bank cannot be said to be meeting the challenge of the circumstances…The Bank has not adequately realized that it is an agency charged by the United Nations with the duty of promoting economic development" (UN

1951: 82-3). The report then goes on to propose the creation of an International Development Authority in the UN for the express purpose of overcoming the many limitations of the Bank.

The World Bank vigorously fought the proposal, and because of its financial autonomy, the UN could do little to change its policies. As one Bank staffer charged at the time with negotiating with the UN put it laconically: "They [the UN] are the central global body, and they feel they ought to be able to exercise authority over all the other international agencies. On the other hand, the Bank has the money" (WBOH 1961c: 20). But by the late 1950s, the Eisenhower administration—faced with the movement of the Cold War to "Third World" countries in Africa, Latin America and Asia—came around to the view that more resources were needed to help fight the communist threat. However, the U.S. insisted that the new lending body be housed at the Bank rather than the UN, for the obvious reason that the U.S. had veto power at the Bank because of its governance structure proportionate to shares rather than one country, one vote as in the UN. Most developing countries naturally objected, but since the U.S. would be putting up most of the funding, they could do little about it.

Bank staff ensured that the new the International Development Association (IDA) would be implemented in such a way that it would not negatively impact the Bank's credit. One key point was that while IDA would be run by the Bank, it would have completely separate financial accounts from the non-concessional IBRD lending window. The point, according to a high-level staffer at the time, was to "assure investors in Bank bonds that their interest in the Bank would not be diluted by the diversion of funds into the softer IDA channels" (WBOH 1961g: 34). In reality, this was (and remains) an elaborate fiction, since from the start the same staff worked on both IBRD and IDA loans in all countries around the world.

Bank staff soon saw that IDA had its uses. For a start, it allowed the Bank to offload many of its riskiest borrowers (notably India and Pakistan) to IDA, thus dramatically improving the quality of the IBRD's portfolio. The IBRD's share of high-risk loans fells sharply after IDA was created, from a peak of 27.3% in 1963 to 20% in 1967 and 15% in 1975, "presumably resulting from the introduction of IDA", commented an internal report (cited in Kapur et al. 1997: 933). Eugene Rotberg, a long-serving treasurer of the World Bank, described the importance of IDA to the Bank as follows: "It's more of a safety valve to permit economic and financial support to countries which are not credit-worthy but, if it were not available, would probably get some Bank lending at the margin and, in so doing, I believe jeopardize the financial credibility of the Bank" (WBOH 1994: 31). Further, IDA provided a useful means for easing pressure on the allocation of IBRD net income. By 1964, reserves had grown so large that the Bank feared the U.S. Congress would try to redirect it to the UN. Hence the Bank began making allocations out of IBRD net income to IDA—thus keeping the resources "in house" due to the extensive overlap between IBRD and IDA operations.

Summarizing World Bank Findings

The World Bank was originally founded as a New Deal-type organization, controlled by member governments and with fundamentally political aims. However, the model designed at Bretton Woods was quickly overturned. To access sufficient resources to establish itself as a meaningful development bank, it had to be able to issue bonds at attractive financial terms. And if the Bank was to access the markets, then logically it would be obliged to institute operational policies that ensured a track record of repayments and organizational finances sufficiently strong to win the approval of ratings agencies and investors, who had little or no interest in the Bank's development mission. This led directly management ascendency in controlling bank policy over the executive directors, the specific project ethos that restricted lending to "profitable" projects, a focus on creditworthiness as opposed to country need to determine lending allocations, deep investigation and involvement with borrowing country macro-economic policy and a fixation with generating net income and reserves.

In his analysis of the same time period in the Bank's history, Chwieroth (2008) argues that the rise of project-focused lending practices was due to normative entrepreneurship on the part of key staffers, rather than the influence of capital markets and resource dependence (which the author also explicitly acknowledges). Hence, in Chwieroth's view, this is a case of organizational change "from within." The evidence reviewed here complements this analysis, but points to a slightly different conclusion: that the Bank's organizational culture was indeed a key factor in shaping operations, but that it was itself deeply shaped by an external factor: the need to secure resources from bond markets.

Despite the single-minded obsession with securing resources from bond markets, the Bank was not simply a financial institution focused only on credit risk and the financial bottom line—it was (and is) a deeply political organization. The growing awareness among wealthy nations of poverty in the rest of the world and the social tensions it could lead to, as well as the unhappiness with the Bank's restrictive policies, led to the creation of IDA. The advent of IDA began shifting the World Bank's operations more toward social aspects of development and poverty alleviation, rather than just heavy infrastructure. But the obsession with running the World Bank in a way that would please bond markets was by then deeply ingrained and would only change going forward at a very slow pace, as highlighted by Chwieroth (2008).

The schizophrenic character of the World Bank—proclaiming its allegiance with the poor while at the same time keeping a constant watchful eye on its financial bottom line—was replicated in subsequent MDBs, although with different dynamics due to varying shareholder interests and international circumstances.

Inter-American Development Bank: A New Kind of MDB?

The creation of the Inter-American Development Bank (IADB) was in many ways a direct result of the conservative lending policies of the World Bank outlined above, coupled with the changing strategic views of the U.S. Latin American countries were clamoring for large amounts of external capital to build up their domestic industries, but the World Bank could not (or would not) supply either the quantity or type of lending the region desired. In the 14 years between 1947 and 1961, the Bank lent a total of US$1.3 billion to all of Latin America, and in line with the specific project ethos, fully 90 percent of Bank lending was for electric power and transportation (World Bank, 1962). Not a single loan was dedicated to state-run or private domestic industry—the main preoccupation of Latin American governments at the time—or for any social projects such as water supply, housing, or education (Ibid.).

The Organization for American States (OAS) organized a series of conferences in the mid-1950s to address the region's external financing needs, and proposed creating a new regional development bank. Conference participants criticized the World Bank for lending too little, not lending to countries that did not follow determined economic policies, restricting loans to only a few types of projects and charging too high an interest rate (Broide, 1961). By contrast, the proposed new bank would support "certain operations that might not generate income to cover the financial service payments, but should be nonetheless granted as they are necessary to increase the productivity and quality of life of Latin American countries," such as sewage, housing and water supply (Ibid.: 82, author's translation). But because the proposed bank lacked U.S. support, the agreement was never ratified.

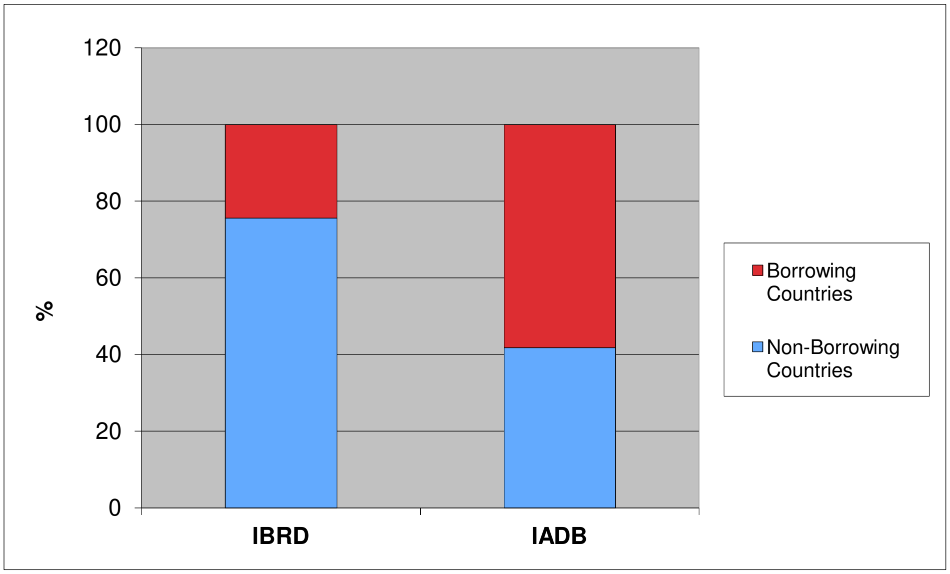
During the late 1950s, however, the U.S. began to be concerned over the potential for instability and threat to its global strategic interests in the region. The growing Cuban insurgency led by Fidel Castro against a pro-U.S. dictator, coupled with Vice-President Richard Nixon's disastrous tour of South America in early 1958—during which he was greeted by angry mobs at all his stops and nearly assaulted in Caracas—brought home the depths of antipathy felt toward the U.S. in the hemisphere. As the Economist put it, referring to the bank proposal: "This is a Latin American dream, regularly spurned as unrealistic by the United States until Vice-President Nixon's unfortunate experiences last year made the Administration realize that it might be a good thing to make a dream come true" (1959: 273). U.S. support for a regional development bank was announced in August 1958.

Once the U.S. was on board, creation of the new bank moved ahead quickly, and it did so almost entirely on the terms dictated by the U.S. Unsurprisingly, the U.S. proposal hewed very closely to the model of the World Bank in terms of capital structure and overall operational policy. However, the U.S. proposed innovations to address Latin American concerns. The most notable was the creation of a concessional lending window akin to IDA—the Fund for Special Operations (FSO)—as an integral part of the new bank, to provide low-interest financing for countries not able to pay market-based rates of the ordinary lending window ("Ordinary Capital", or OC), and for specific projects considered less "bankable". The IADB's charter also permitted more flexibility than the World Bank to make loans directly to private industry without requiring a government guarantee, an important demand of Latin American countries intent on developing their domestic industrial base (IADB, 1996) but considered by the World Bank to be too risky from a repayment point of view.

U.S. support came at a price. The original 18 Latin countries had a majority share on the IADB's board, and hence in theory could join together to out-vote the U.S. This contrasts with the World Bank, in which industrialized countries controlled 75.6% of total voting shares in 1960 (Fig. 2). But the U.S. demanded veto power over FSO operations, due to the fact that it contributed two-thirds of the initial resources of the concessional fund, as well as veto power over changes to the IADB's capital structure or charter (Ibid.).[12] There is no record of dissent on this point during the convention, nor was there serious opposition to naming Washington DC to be the bank's headquarters (Broide, 1961), which suggest that the Latin countries were well aware of the limits of the U.S.'s benevolence.

[12] The U.S. has also always held veto power over changes to World Bank capital structure and charter, though it does not have a formal veto over IDA operations.

Figure 2. Voting Power at the IBRD and IADB



Source: Annual reports World Bank and IADB, 1960.

Borrowers' Honeymoon

The dominance of the U.S. was not a cause of conflict in the early years of the IADB's existence, for the simple reason that the interests of both the U.S. and other member governments were relatively closely aligned. All parties wanted to ramp up the flow of external capital to Latin America and to undertake loans that the World Bank did not consider, in particular for social projects and industry. Concessional lending quickly assumed a large role in the new bank. The Kennedy and Johnson administrations funded FSO lending to the tune of US$2.275 billion between 1960 and 1967.[13] As a result, US$1.46 billion of the IADB's US$2.43 billion in total

[13] The U.S. created the Social Progress Trust Fund as another concessional lending window within the IADB under direct U.S. control in 1960, but by 1965 it had been merged into the FSO.

lending commitments up to 1967 (63%) was at concessional interest rates, while the remainder was at the regular lending rate. By contrast, of the World Bank's US$7.2 billion in total global loan commitments over the same period, only US$1.7 billion (24%) was in concessional lending.

Because of generous U.S. support, the IADB was considerably less exercised than the World Bank had been in its early years to ingratiate itself with private capital markets. As one early observer of the IADB noted, "The bank has not felt itself constrained, as its sister institutions have done, to tailor its operations to fit the assumed expectations of the prospective purchasers of its bonds" (White 1975: 182). Also, the task itself was much less difficult than it had been in the late 1940s, because of all the work the World Bank had already done to ease market concerns about a multilateral bank. The IADB's first debt issuance in the U.S. was rated AAA with a minimum of fuss, and sold out in short order at the same terms as World Bank bonds in the same year (IADB, 1963). Thus, the very same conservative financial policies of the World Bank that in large measure led to the creation of the IADB allowed the new bank to immediately differentiate itself from its predecessor in ways that suited both its borrowing members and its dominant shareholder.

The strong U.S. commitments of concessional resources gave the IADB considerable leeway, both rhetorically and operationally. The Economist magazine, in an article on the IADB's creation, noted that the new bank's goals included "rather striking new specifications for social reform" (1960: 241). The very first loan made by the IADB was for a water and sanitation system in Arequipa, Peru—a clear statement of the new bank's intentions (IADB, 1961). Lending in the early years of the IADB followed these new priorities. Two-thirds of all lending commitments in the first four years of operations were for industry and social infrastructure, compared to only 4% by the World Bank in the same years to Latin America and 15% globally.[14] By contrast, only 10% of total IADB lending was for electric power and transportation infrastructure, compared to 88% for the World Bank in Latin America and 70% globally.

The IADB also lent to all member countries, regardless of their policies or relationship with the U.S. One interesting case in point was Brazil, governed by a left-leaning administration from 1958 to 1964 that vocally opposed the U.S. The World Bank granted no loans to Brazil between 1958 and 1965, while the IADB granted numerous loans every year to Brazil, with no apparent objection from the U.S. Similarly, Colombia engaged in a heated dispute with the IMF in the mid-1960s over macroeconomic policies (Dell, 1972), which led a halt in World Bank lending during 1965. Again, the IADB continued lending to the country throughout. It would seem that the U.S., intent on repairing relations with the hemisphere, was willing—for the time being—to resist the temptation to use its power in the IADB to further its own interests, and allow the IADB to build a reputation for solidarity among Latin Americans.

Something New—But Will it be Sustained?

By 1968, the U.S. was looking at a dramatically different set of circumstances than at the start of the decade. In Latin America, the U.S. was actively supporting the growing militarization of the region's political systems, which limited the threat of communist takeovers. At the same time,

[14] The difference between Latin American and world lending sectoral breakdowns for the World Bank may indicate a small degree of substitution effect, with the World Bank taking into account the IADB's operations.

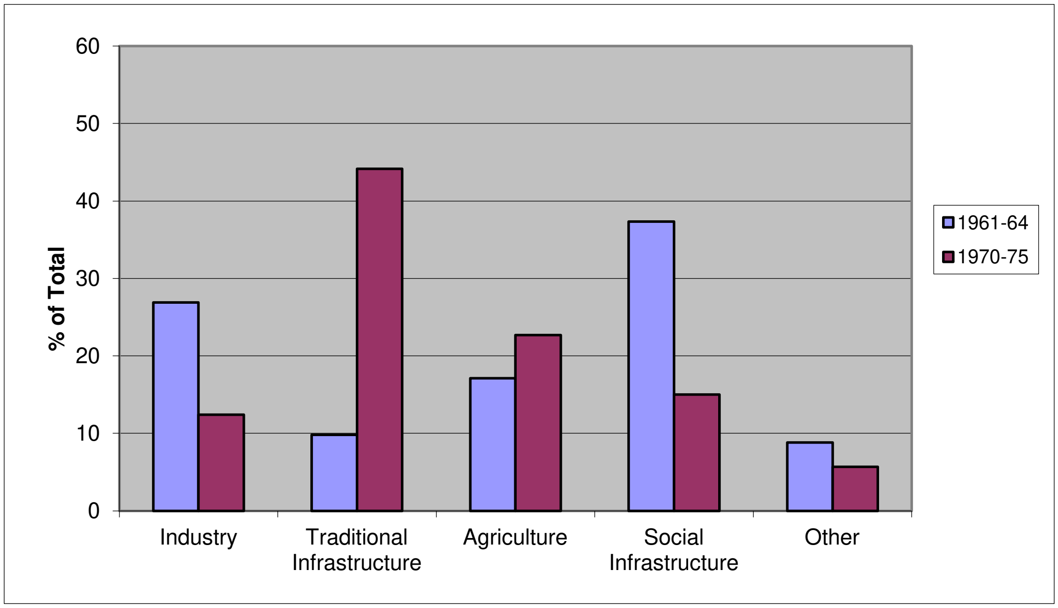
Vietnam had become an expensive fiasco, domestic fiscal policy was escaping control and the country was facing increasingly severe balance of payments problems. Support for foreign aid in the U.S. Congress was on the decline. In light of these developments, the U.S. began scaling back contributions to the IADB. After giving over US$2 billion in concessional resources in the first eight years of IADB operations, it contributed only US$500 million in the subsequent eight years, and that only after long delays by Congress. The U.S. also began to block lending to countries with which it had business disputes, notably nationalization moves against U.S. companies in Chile and Peru. Leftist Peruvian President Juan Velasco railed against the U.S. at the 1971 Board of Governors meeting in Lima for halting loans to his country because of a nationalization dispute—a sign of the tensions brewing at the IADB: “We believe that the time has come for a calm and complete reappraisal of the real effectiveness of an institution which, like the Inter-American Development Bank, shows signs of being used as a tool for political pressure against countries which, like Peru, are determined to break with the past” (IADB 1971: 26).

Declining concessional contributions coupled with the growing interventionist attitude of the U.S. in lending operations spurred IADB management to seek new sources of funding. The IADB management saw greater use of OC compared to FSO resources as a way to make the IADB less susceptible to U.S. pressure, as President Antonio Ortiz Mena spelled out in a 1973 speech: “…it is perfectly clear that the Latin American countries as a whole have sufficient voting power to approve loans granted with the ordinary resources of the Bank. A very different case is that of the Bank’s operations financed with the resources of the Fund for Special Operations” where the U.S. had a veto on all loan approvals (IADB 1973: 48). If the Latin countries wish to reduce the power of the U.S. in IADB operations, then strengthening the OC window and depending less on FSO was the way forward.

Ramping up non-concessional lending, however, required the IADB to have access to a steady stream of bond purchasers. This, in turn, required the IADB to pay much more attention than previously to convince the markets that its securities were a safe investment, much like the World Bank. Thus it comes as no surprise that by the early 1970s, IADB operational and financial policies increasingly began resembling the World Bank's. In a 1972 speech to the IADB's Board of Governors, Ortiz Mena alluded to the need for the IADB to pay close attention to the views of bond holders when considering loan applications in light of the greater need to raise money on the markets: "…we should bear in mind that the financial soundness of the Bank and its loan portfolio is subject to constant appraisal when it has recourse to capital markets" (IADB 1972: 157).

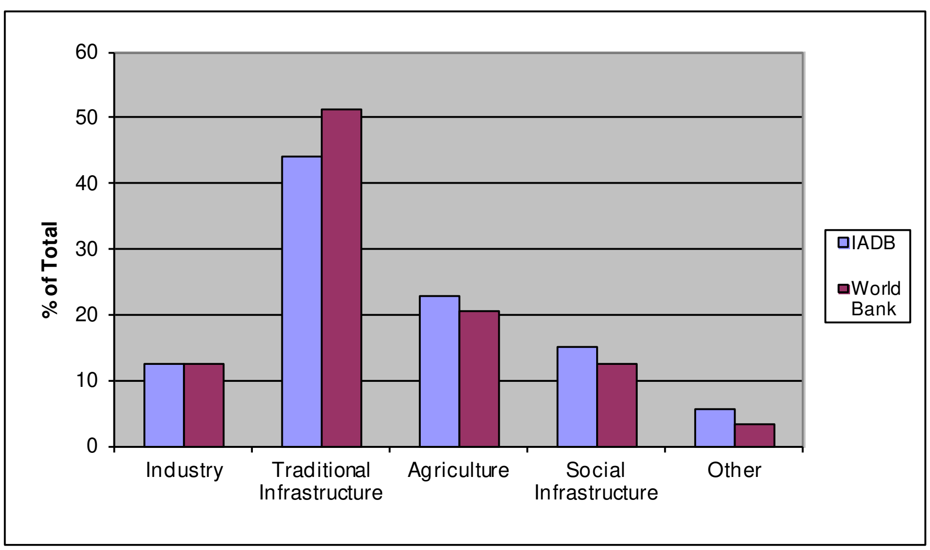
The change was most dramatic in what types of projects the IADB supported in the first half of the 1970s compared to a decade earlier. The IADB's early enthusiasm for lending to industry—a Latin American priority—began to abate. By 1970 direct private lending had dropped to only 6% of total OC lending, and it was cut off entirely after that year, while loans to national development banks fell from 46% of OC commitments in 1961-64 to 14% in 1970-74. Social infrastructure lending also declined sharply. By contrast, the IADB rapidly scaled up lending to traditional infrastructure projects such as highways and electric power (Fig. 3). This new pattern was very close to the lending priorities of the World Bank, in sharp contrast to their divergence in the early 1960s (Fig. 4).

Figure 3. IADB Commitments by Sector



Source: IADB annual reports, 1961-64 and 1970-75. Includes both non-concessional (OC) and concessional (FSO) lending windows.

Figure 4. World Bank and IADB Commitments by Sector, 1970-75



Source: IADB and World Bank annual reports, 1970-75. Both MDBs include the concessional (IDA and FSO) and non-concessional (IBRD and OC) lending windows.

Branching Out to Non-Regional Members

The IADB faced another problem starting in the early 1970s: with its growing balance of payments difficulties, the U.S. government limited IADB bond issues in the New York market (IADB, 1970a). The only other markets available for bond issues were in Europe and Japan, but the IADB faced serious obstacles in accessing those markets, including regulations, high taxes (up to 2.5% per issue, compared to the tax-exempt status of World Bank bonds) and outright prohibitions (IADB, 1965a). The key point was membership, as the IADB acknowledged in a 1965 study: "The IADB has found that these countries give preference to certain countries linked to them politically or economically, or to international institutions of which the country is a member" (Ibid.: 65, author's translation). Europeans understandably viewed the IADB as dominated by the U.S., and they had no interest in offering it the advantages enjoyed by international organizations such as the World Bank or the European Investment Bank, which they were members of and had a voice in. The only mechanism by which non-member countries offered significant capital was loans or credit lines tied to purchases of export goods, which the IADB accepted grudgingly, as President Herrera noted in 1965: "We have made it clear that the Bank's role in these transactions is not that of an instrument designed to promote exports by developed countries" (IADB 1965b: 16, author's translation).

In his farewell address to the Board of Governors in 1970, President Herrera stated that financial pressures were leading the IADB to reconsider its original intention of limiting membership to countries in the region: "In the case of non-member countries, this encourages us to seek other formulas designed to maintain an adequate additional flow of resources…including possible formal association of those countries with our organization" (IADB 1970b: 67). Canada was admitted to the IADB with little controversy in 1972 (IADB, 1973), but the financial impact was minimal. A more thorny matter was the admission of prospective members from Europe and Japan. From the point of view of the IADB, these countries represented a critical financial lifeline, as noted by Ortiz Mena in 1973: "Their membership will facilitate our access to certain capital markets on more favorable conditions than at present…Furthermore, the diversification of sources will help diminish the possibility of sharp fluctuations in the flow of funds received by the Bank" (IADB 1973: 50).

The move to bring in countries from outside the region did not sit easily with all borrowing countries. Peru's representative to the IADB Board of Governors gave guarded approval to the expansion: "…we trust that before long we may be able to extend an equally cordial welcome to other countries of Europe and Asia, on the understanding that their presence will not imply political interference…" (IADB, 1972: 7-8). Speeches by the representatives of Argentina, Venezuela and Peru at IADB meetings in 1973 and 1974 also voiced suspicion of admitting non-regional members, and spoke of the need to "Latin Americanize" the bank, including an unsuccessful proposal to move its headquarters to Latin America.

Despite these misgivings, nine non-regional countries were admitted on July 9, 1976: Belgium, Denmark, Germany, Israel, Japan, Spain, Switzerland, United Kingdom and Yugoslavia. The new members contributed US$372 million to FSO and US$372 million in ordinary capital, of which US$61.5 million (16.5%) was in cash and the remainder on call. Equally important, new members granted the IADB full legal and tax status as an international organization, and facilitated the placement of bonds in their capital markets. The results were immediate. IADB debt issued in non-member countries had averaged US$53 million per year in 1961-75, but that immediately jumped to US$252 million in 1976—almost twice the previous record amount in one year (US$145 million in 1969) (IADB AR 1961-76). In 1977 the IADB floated its first public bond in Japan, and borrowing also ramped up sharply in the German and Swiss markets (IADB AR 1977). This new level was sustained going forward, with the IADB issuing on average US$221.5 million each year 1976-1980 (IADB AR 1976-80).

Summarizing IADB Findings

The IADB was created directly in opposition to the World Bank. Its aim was to lend for development projects that the World Bank would not touch, especially social infrastructure and private industry; to offer more concessional resources; to reduce political influence in lending; and to generally take a less market-focused view of its development mission. It was successful in all these areas in the first years of its existence, specifically because of the very high level of concessional resources committed to it by the Kennedy and Johnson administrations, in reaction to U.S. fears of social revolt in the Americas.

But as U.S. support for concessional lending began to wane and IADB's access to New York markets was restricted in the late 1960s, the model quickly began showing its limitations. By 1970, the IADB shifted its focus to non-concessional lending, which didn't depend on U.S.

contributions and also afforded Latin countries greater operational control due to voting rules. The shift to non-concessional lending, however, necessitated greater access to private markets to raise capital. This in turn led to a dramatic change in lending patterns, away from social infrastructure and private industry and toward the type of power and transport projects favored by the World Bank to impress potential bond buyers. And in a bid to access more resources in the face of restricted U.S. capital markets, the IADB sacrificed a degree of its Latin American character and allowed members from outside the region. Thus the evolution of the IADB between its founding in 1959 and the mid-1970s puts in sharp relief how the pressures of securing the resources needed to function to a large measure dictated not only the bank's operations but its very membership structure.

CAF: The Challenges of Going it Alone

Like the IADB, the Andean Development Corporation (*Corporacion Andina de Fomento*—CAF)—founded in 1968—was envisioned by its creators to be a new sort of MDB, one that would undertake a different type of development activity than either the World Bank or the IADB. The CAF was to promote economic integration among its six South American member countries, Bolivia, Chile, Colombia, Ecuador, Peru and Venezuela, as part of broader regional integration efforts prevalent in Latin America at that time. The operational structure of the CAF mirrored the World Bank and IADB in many important respects, including government ownership and a loan-based financial model. Within this broad model, however, the CAF differed from the World Bank and IADB in a number of important respects.

Most notable was the composition of the shareholding countries themselves: they were all developing countries expecting to borrow from the CAF. As well, participating countries would have more equitable control over the CAF through the creation of different types of shares, which allowed wealthy countries (Chile, Colombia, Peru and Venezuela) to contribute more capital, but still giving poorer countries (Bolivia and Ecuador) significant voting power (Fresard, 1969). The orientation of the CAF's financial services was also intended to be markedly different from the World Bank and IADB. Industry, and to a lesser extent agribusiness and trade support, were to be the explicit and exclusive focus of the CAF's activities (Ibid.). Financial support could be supplied in a broader range of ways than other MDBs, including to "emit bonds or debentures, act as a guarantor of any type, provide collateral for obligations, and grant guarantees in share issues", i.e. act as an underwriter (CAF, 1974, Art. 4).

Among the many problems facing the CAF when it opened its doors for business in 1970, by far the most pressing was raising resources with which to operate. The six founding countries had committed US$25 million in capital, but this would only be paid in over the course of several years, making it essential that the CAF quickly find other sources of capital to intermediate. The expectation was that this capital would mainly come from outside the region. As the Chilean negotiator blithely stated, "…the majority of the resources that the Corporation will employ will not come from its own capital, but from traditional sources available in the developed world for the purposes of economic and social development" (Fresard 1969: 33, author's translation), evidently meaning soft loans from bilateral aid agencies of developed countries or other, larger MDBs. As well, the CAF intended to issue debt on private capital markets in Europe and North America, as envisioned in its charter.

Initial impressions seemed positive: U.S. AID provided a US$15 million soft loan in 1971, and Canada soon followed suit with another US$5 million. Further financial contributions were expected from the World Bank and the IADB (CAF AR 1971: 33). The CAF sent out a financial mission to Europe, Japan and North America in 1971 to test the waters regarding access to other public and private sources of capital in the form of credit lines, bond issues and bank loans. The mission reported receiving a "favorable and positive impression on the aims of the organization" (Ibid.: 34, author's translation) in international financial circles. One of the stops was in Switzerland, where CAF officials met with the banking giant UBS to "understand the conditions under which the institution could in the near future place in the world capital markets a long-term bond issue" (Ibid.: 34, author's translation).

Harsh Realities

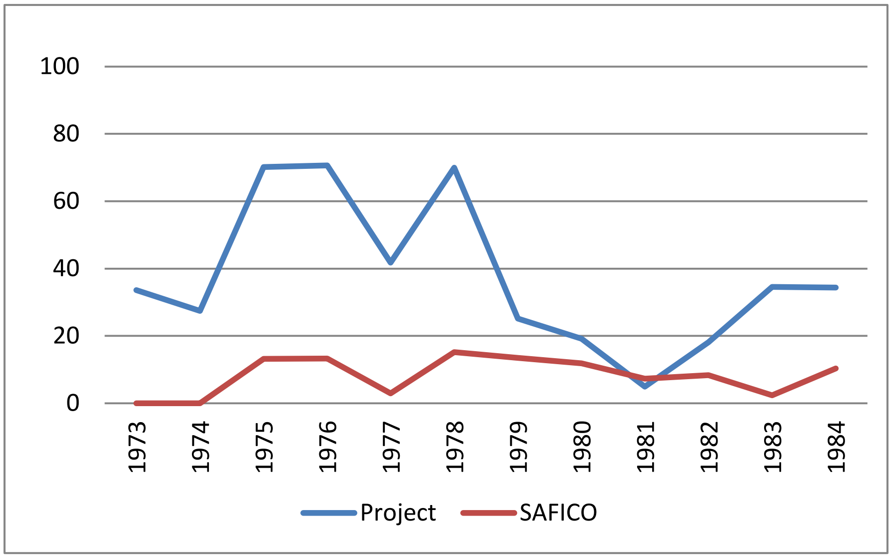
These optimistic plans soon came up against a much less forgiving reality. U.S. AID's loan, which the CAF saw as just an "initial" contribution (Ibid.: 34, author's translation), was never increased, nor was the Canadian loan. Efforts to raise money from European governments were similarly limited, with the 1975 Annual Report reduced to playing up the fact that a CAF European mission had even been received by "high officials" at all (CAF AR 1975: 16, author's translation). The IADB was similarly uncooperative. After an initial loan of US$750,000 for technical assistance purposes, no further resources were forthcoming. Hopeful mention is made in the 1974 Annual Report of obtaining from the World Bank "technical and financial cooperation for the programs of the CAF and, eventually, a line of credit" (CAF AR 1974: 25, author's translation), which never materialized. With U.S. enthusiasm for development aid dwindling, and the lack of any shareholding influence by the U.S. or European nations, developed country governments apparently saw little incentive to supply resources to the CAF.

Progress was even slower with the private markets. Neither U.S. nor European capital markets showed any inclination to invest in CAF bonds. Following a 1974 mission to New York investment banks, the CAF concluded that "during 1975 there will be possibilities to raise US$15-25 million in a private placement, as a first step before a future public offer" (Ibid.: 23, author's translation). No such placement took place. Talks with European and Asian banks that same year were similarly fruitless. Even with the huge boom in petrodollar lending to Latin America, it was not until 1977 that the CAF was finally able to conclude a sizeable bank loan, for US$50 million from a syndicate of European, Japanese and U.S. banks. With no developed country to back up its financial obligations—only six relatively poor Latin American countries, two governed by leftist administrations whose leaders regularly railed against the evils of capitalism—financiers in developed countries were not enthusiastic about lending it money.

Like the IADB in the 1960s, credit lines and loans tied to exports were the only significant financing offered by countries outside the Andean region: US$6 million each from Brazil and Mexico in 1973, US$10 million from Japan's Ex-Im Bank in 1974, various projects purchases funded jointly by the U.S. Ex-Im Bank and Bank of America (at high interest rates) and US$10 million by the Spanish Export Bank in 1977 (CAF AR, 1973, 1974 and 1975). As with the IADB, the CAF sought to avoid credit lines tied to exports, as they restricted the usefulness of loans to borrowers. The 1973 Annual Report highlights "the necessity that [external] loans and credit lines be granted totally untied and in conditions that facilitate their use in programs compatible with the necessities of the CAF" (CAF AR 1973: 20, author's translation).

If the CAF's liability situation was difficult during its first decade, its asset side was equally so. Right from the start the bank ran up against the tensions between its idealistic mandate of promoting regional integration and the more parochial desires of individual member governments. The CAF sent out an initial mission in 1971 to put together a portfolio of potential projects. However, as that year's annual report noted, "The most common characteristics of these projects and initiatives was their limited integration content. The majority had strictly national characteristics…" (CAF AR 1971: 21, author's translation). This problem was mentioned repeatedly in early annual reports. The solution was to partially relax the CAF's standards in the interests of making loans. In an article describing this period, the CAF's second president recalled that "pressured by the need to survive, the CAF had to move ahead with projects that were not strictly in accord with the restrictive parameters of its mandate" (CAF 1990: 28, author's translation). That is, the CAF's original core mandate of promoting regional integration quickly took a back seat to the necessity of finding projects to fund.

Figure 5. CAF Lending Commitments (millions 1973 US$)



Source: CAF annual reports, 1973-1984.

Note: SAFICO refers to short-term trade finance of not more than 90 days.

By partially relaxing its project lending requirements and initiating short-term trade financing (called SAFICO), the CAF began to build lending, with annual commitments rising from US$33 million in 1973 to US$107 million in 1976 (of which US$17 million was trade financing). However, lending reversed sharply in 1977 as a result of the withdrawal of Chile as well as reduced demand for loans by member governments due to easy access to petrodollar syndicated loans, and continued on a downward trend to 1981 (Fig. 5). Equally troubling was the CAF's operating results, with three years of net losses (1975, 1977 and 1978), reflecting not only to difficulties finding appropriate projects but also the CAF's high cost of funding, which made it problematic to on-lend at terms that were both acceptable to borrowers and able to generate net income for the CAF.

Changing Direction in the 1980s

By 1981, the CAF's finances were in a precarious state, with only US$15 million in loans committed that year. From this low point, the CAF began reorienting its strategy and rebuilding itself as a viable financial intermediary. Leaving behind an operational model predicated on mediating bilateral and multilateral resources that never materialized and hamstrung by a mandate to promote a regional integration process that was at best stagnating, the CAF began to reinvent itself as an MDB much closer to the model of the IADB and World Bank. In his 1981 inaugural speech, President José Corsino Cárdenas called for the CAF to "adjust its institutional structure and launch new initiatives such that it can convert itself into…a true financial agent for its shareholders and an organization that does more than just survive" (CAF 1981: 13, author's translation).

This meant, first and foremost, revamping the CAF's operational activities to boost its attractiveness as a potential lender. The board approved a new Operations Policy in 1983, "broadening the realm of activities for the promotion, development and financing of projects" (CAF AR 1983: 7, author's translation). The aim was to "overcome the limitations of the existing operations policy, designed basically for industrial programming and free trade within the Andean Group" and now "attend more directly the sectors that most contributed to the economic development of the countries such as agriculture, agroindustry, physical integration, and other areas previously not addressed by the CAF" (CAF 1986, author's translation). In other words, regional integration—the CAF's original raison d'etre—was no longer the top of even main priority of lending, but rather projects of national interest. As well, CAF loans increasingly went directly to governments or government-run companies and development banks, rather than higher-risk private sector borrowers—similar to the trend in IADB lending in the late 1960s and early 1970s.

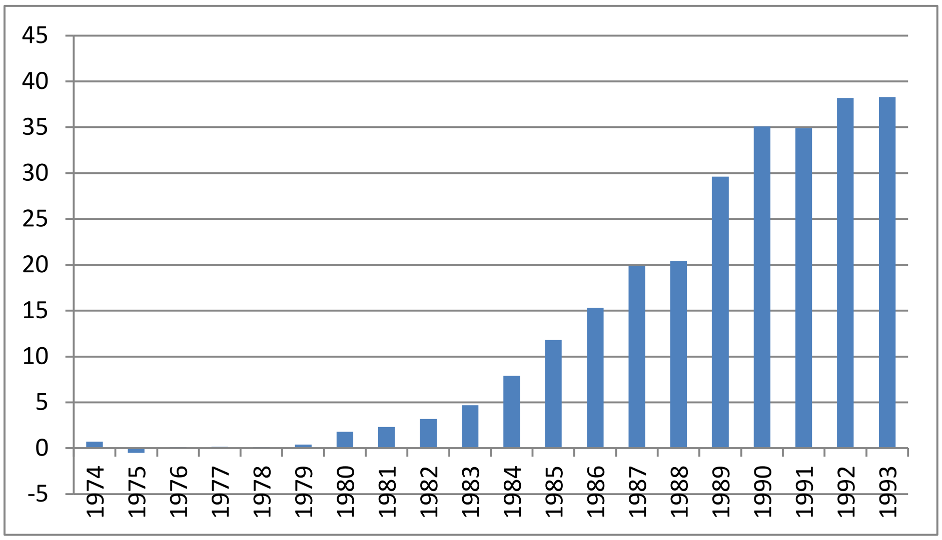
As a result, CAF lending stabilized and began growing again in the 1980s, partly assisted no doubt by the dire need for financing by member governments during the post-1982 crisis years. Project loan commitments climbed from US$40 million in 1982 to US$263 million in 1990 (CAF AR, 1980-1990). Perhaps as importantly, the CAF began selecting projects much more carefully, as indicated by the reduction in cancelled projects from 43% of total value during 1971-1980 to 10.6% in 1982-1986 (CAF, 1986). The overall financial stability of the institution was on a much more solid foundation, with net income up from US$1.8 million in 1980 to US$35 million in 1990 (Fig. 6).

The evolution of reserves is even more telling about the CAF's metamorphosis. Reserves were actually in negative territory for much of the 1970s, after being used to cover operating losses in 1976 and 1978, and totaled a mere US$300,000 in 1980. The incoming administration in 1981 began systematically building reserves each year, evidently cognizant of the importance of building up the CAF's reputation as a solid financial institution in the eyes of potential suppliers of capital. By 1986, reserves totaled US$22 million, climbing to over US$100 million in 1990 (Figure 7). This, it should be noted, came at the expense of borrowers, who paid higher interests rates on their loans to generate resources for reserves.[15] As well, the administration convinced

[15] The use of higher interest rates to generate net income for, among other uses, reserves, is a highly contested issue between borrower and non-borrower shareholders at the IADB and World Bank, as discussed in Humphrey (2013). That has never been a topic of significant conflict at the CAF, since the shareholders and borrowers are one and the same, and all had and have an interest in the CAF's financial strength.

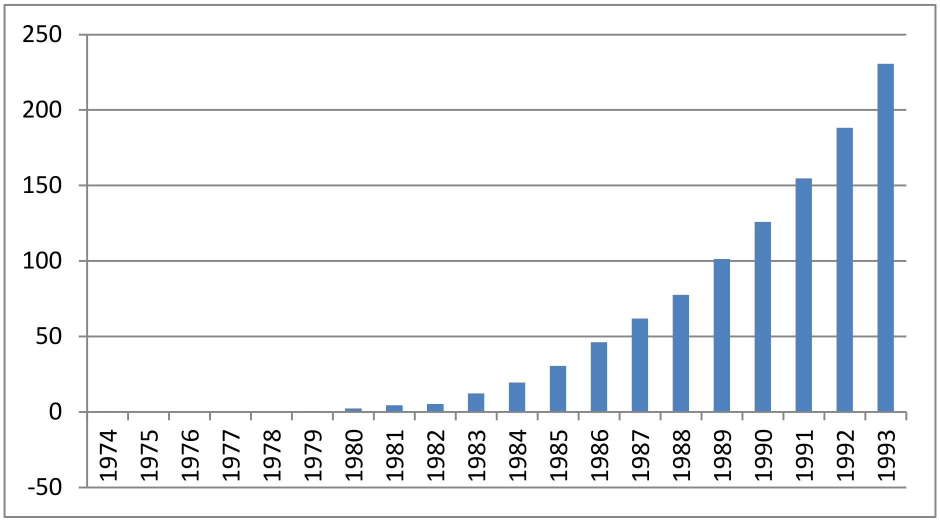
shareholders to allow the CAF to keep unallocated net income on its books as it began to accumulate in the 1980s, rather than redistributing it to shareholders. By 1990, accumulated net income totaled US$28 million—useful to generate extra interest income, as well as a liquidity cushion offering additional confidence to potential investors.

Figure 6. CAF Net Income (millions current US$)



Source: CAF annual reports, 1974-1993.

Figure 7. CAF Reserves + Retained Earnings (millions current US$)



Source: CAF annual reports, 1974-1993

Coming Into Its Own

As was the case with the IADB in the 1960s and early 1970s, it was increasingly apparent to the CAF that bilateral and multilateral sources of soft loans would be limited and fickle, and the more easily available bilateral credit lines tied to exports of developed countries severely restricted the CAF's ability to fund different types of projects. The answer would be private capital markets, as President Galo Montano stated in a 1989 speech: "Our interest in freeing ourselves from the dependence on the type of resources that we currently channel has led us to study ways of raising resources on the international market" (CAF 1989: 10, author's translation). The overhaul of operations and finances to stabilize the CAF and project a more conservative, financially reliable image positioned the CAF well when international capital flows to developing countries began to pick up again in the 1990s.

One point in the CAF's favor from the point of view of potential creditors was the fact that no sovereign borrower had ever defaulted on a loan, even though four of the CAF's five member governments were in default to international markets at some point. Even when Peru suspended paying international debt and fell into arrears with the World Bank, IMF and the IADB in the mid-1980s, it continued servicing all obligations to the CAF.[16] This repayment record—far superior to that of the World Bank and IADB[17]—highlights the fact that the CAF's borrower-only membership structure engenders a strong sense of ownership and responsibility among borrowers.

Indications that others outside the region were beginning to take notice of the CAF's unsurpassed repayment record and the reforms to its operations came in 1989, with the first placement of a US$2.5 million private bond with First Interstate Bank, followed the next year by a three-year, US$15 million bond placed privately in Japan at the attractive rate of Libor +1% (CAF AR 1989 and 1990). This was a critical sign of confidence of the private markets in the CAF's financial probity. In 1990 the CAF received US$30 million in untied credit lines from German and Dutch banks, and further untied loans from First Interstate for US$8 million (CAF AR 1990). Another indication of shareholder confidence was the increase in authorized capital by US$1 billion in 1990, to a total of US$2.05 billion (CAF AR 1990).

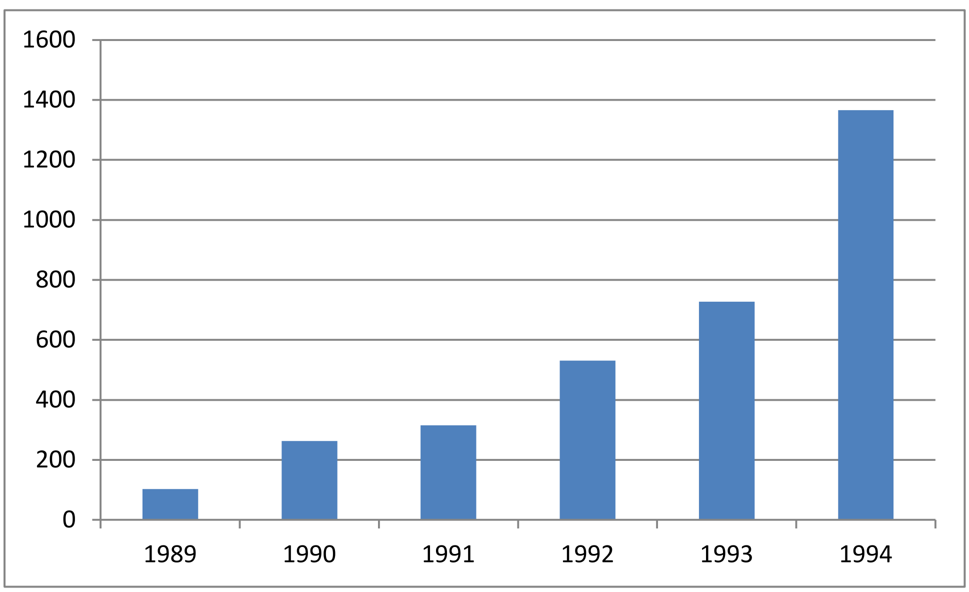
[16] As of end-2012, it remains the case that no CAF loan to sovereign borrowers has ever gone into arrears.
[17] A total of 22 countries have fallen behind by six months or more since the World Bank's inception, including six in Latin America (Nicaragua, Guyana, Peru, Panama, Honduras and Guatemala). A number of these countries did not paid their loans for several years, including eight years for Nicaragua (1984-1992) and six for Peru (1987-1993). As well, while the World Bank has never written off a loan in a strictest sense, it has removed non-performing loans from IBRD's balance sheet by moving them to IDA and also as part of various debt relief initiatives. The IADB has had five sovereigns going into non-accrual (no payments for six months or longer) since 1960, and shorter arrears have been very common. The IADB has also removed loans in arrears through debt relief initiatives.

The quantum leap in the CAF's performance came with the arrival of Luis Enrique García as president in 1991. An IADB staffer for 17 years, García completed the transition of the CAF's business model to one much closer to the IADB. He was clear about his goal right from the start, as he described in a later interview: "When I joined the CAF, particularly because of my experience with the IDB, I saw the future of the CAF as an institution relying essentially on CAF's ability to tap the international capital market. Because if it was only relying on the old capital or short term lines of credit or even loans from the IDB, the institution really had no chance to grow" (Latin Finance 1998: 147). Thus, while the CAF was already being pushed by the realities of its organizational model and finances in the direction of the other two MDBs, García had the experience and clarity of vision to see that process through.

But for the CAF to raise significant resources on the markets at a price that permitted the CAF to on-lend at reasonable rates, "it was a must to have an investment grade rating," García noted in the same interview (Ibid.). Immediately after taking charge in 1991, García traveled to New York to obtain a rating from Standard & Poor's and Moody's. This was an ambitious request, considering that not a single borrower in Latin America had investment grade, and that four of the five government shareholders of the CAF were among the most notorious debt trouble spots in the world during the 1980s. The CAF hired consultants from Coopers and Lybrand and a former World Bank vice president to review the CAF's operations and make recommendations for overhauling internal process, and revised operational and financial policies "with the aim of broadening its sources of financing" (CAF AR 1992: 57, author's translation).

As with the IADB in the 1970s, the CAF found it expedient to set aside its character as an Andean organization and accept new non-Andean members with the specific aim of better access to capital markets. Mexico joined in 1990, Chile returned in 1992 and Trinidad and Tobago joined in 1993, although from the start García expressed his intention to bring in developed countries as well: "Not only the incorporation of other regional countries, but to fix as a goal the incorporation of industrialized countries. This will significantly facilitate the access of the CAF to international markets" (CAF 1991: 17-18, author's translation).

Figure 8. CAF Project Lending Commitments, 1989-94



Source: CAF annual reports 1989-1994.

Standard & Poor's issued the CAF an investment grade rating in 1993, soon followed by Moody's and IBCA (CAF AR, 1993). During the same year, the CAF promptly issued three public bonds for a total of US$289 million, US$200 million on the Eurobond market and US$89 million Japanese "samurai" bonds (Ibid.). In one year the CAF raised more freely usable resources from outside the region than it had in its entire previous two decades combined. Project lending commitments increased by more than a factor of 10 in the five years between 1989 ($103 million) and 1994 ($1.4 billion)—a truly remarkable growth rate (Fig. 8). The benefits of the CAF's reorientation toward the private markets were thus immediately clear to all involved.

Summarizing CAF Findings

Like the IADB, the CAF was founded explicitly to address the limitations of existing MDBs, by extending credit to private industry under a regional integration framework and avoiding the US's increasing heavy-handed influence in the IADB. While the CAF's borrower-only membership freed it from the political influence of wealthy countries, it also imposed serious limitations on raising resources. International capital markets showed no interest whatsoever in investing in the CAF, and bilateral/multilateral sources were also wary, seeing little upside to supporting an MDB over which they would have no influence and appeared financially precarious.

Facing the prospect of failure, the CAF began to build a new image of financial probity in the 1980s to access new financing. Shareholders significantly loosened lending policy, the administration was revamped and financial reserves began to build. The hard work of the 1980s, combined with the arrival of President García in 1991 and the admission of new, non-Andean members—specifically with the goal of increasing access to capital markets, as with the IADB in the 1970s—led the ratings agencies to grant the CAF investment grade status in 1993. The investment grade rating and support of new members directly led to the tremendous growth of CAF borrowing and lending that began in the early 1990s and has continued to the present.

By 1994, the CAF's initial parochial vision had given way to a much more open operational style designed to access private markets around the world and to provide whatever financial services its clientele required. Its original vision was simply unworkable, both in the projects it sought to lend to and in its strategy to raise resources. Rather than go out of business, the CAF undertook the reforms it needed to survive and thrive, moving it much closer to the financial model of the World Bank and IADB.

Conclusion

The experiences of the World Bank, IADB and CAF over the course of their creation and early years of operations provide compelling evidence that political and financial pressures combined to generate an almost "ideal" financial-operational model for multilateral development banks, to which each of the three MDBs eventually conformed, despite the original intentions of their creators. The reality that governments would not be willing to supply large amounts of budgetary resources for the MDBs to intermediate required that all three rely increasingly on private capital markets to raise resources. While founders did foresee MDBs utilizing bond markets for funding, the degree of dependence on markets turned out to be much higher than originally planned in each case. The perceptions and exigencies of bond buyers, in turn, pushed the MDBs to modify their operational procedures and even basic shareholding structure substantially different from the original intentions of founders, with the specific aim of securing a reliable source of funding.

Of the three, the World Bank moved most quickly and decisively to incorporate market-based criteria into its operations. This was due in part to the lack of any other options when it began operations, in light of the non-viability of the originally planned use of guarantees rather than direct loans, the unwillingness of any shareholder except the U.S. to allow their capital contribution to be used and the pressing need for resources. The Wall Street ethos quickly established firm control of World Bank operational style, offering loans only to the most creditworthy borrowers for projects expected to generate cash returns in the short term. It was not until the late 1950s, flush with cash and facing growing complaints to lend more, that this organizational culture was diluted to a degree with the creation of IDA. Even this step back toward the development style intended for the World Bank by its New Deal founders was limited, and concerns of financial rectitude remain a high priority, as evidence by continued battles between management and shareholders about loan pricing, reserve levels and net income policy (see Mohammed, 2004 and Humphrey, 2013).

The early trajectory of the IADB demonstrates that an MDB does not in theory require such strong subservience to the whims of potential bondholders, as long as it enjoys strong financial backing from one or more governments. Generous U.S. contributions of concessional resources allowed the IADB to take a radically different approach to development lending, one that emphasized lending much more in alignment with the priorities of borrowing countries and with less obsession with "bankable" projects. Once this U.S. support waned in the late 1960s, the IADB reoriented its operations and even membership structure as a Latin American bank to ensure the resources it needed to continue serving as a lender and to keep U.S. policy pressure at arm's length. By switching the types of projects it supported to a profile much closer to the World Bank and opening up its membership to countries from Europe and Japan, the IADB secured a dramatic increase in available financing, at the cost of its original vision for the kind of MDB it would be.

The CAF's evolution demonstrates the same point, but from a different angle. Its founders intended to differentiate their operations also, but apparently thought they could do so without any wealthy country backing it. The CAF eventually realized, however, that while having only borrowing countries as shareholders offered a notable degree of operational flexibility, finding financing to intermediate from outside its members was another question altogether. Thus by the 1980s it, too, had turned its focus to what it needed to do to gain access to greater external sources of finance. This meant reshaping policies on lending, rigorously building up net income and reserves (at the expense of offering less expensive loans), and opening membership to non-Andean countries. As with the IADB, the original vision of an inward-looking MDB with limited membership concentrating on specific types of projects was left by the wayside when that model proved ineffective. As the subsequent growth of the CAF has shown—now with 18 shareholding countries including Brazil, Argentina, Uruguay, Panama, Spain and Portugal—expanding membership has greatly improved diversified its loan portfolio and capital strength, leading to steadily improving bond ratings and better access to capital markets.

The experiences of the World Bank, IADB and CAF outlined here suggest that whatever the composition of their shareholders, only with major financial support from a wealthy nation or nations is it possible to establish a different kind of MDB from the ones we see today. In the absence of that support, MDBs of necessity must access private financial markets to raise the resources they need to effectively operate. This is in fact one of the great strengths of the MDB model: it is to a large degree self-financing, requiring very little direct fiscal contributions from member countries for regular operations. The flip side, however, is that it also requires MDBs to keep a very close eye on the whims of private capital markets when shaping their operational and financial policies. The similar trajectories of other MDBs—notably the African Development Bank (see Mingst, 1990 and Strand, 2001)—suggest that the patterns discussed here can be applied to MDBs more generally, although doing so is beyond the scope of this paper.

Whether this reliance on capital markets and the operational pressures that come along with it is "good" for development is an extremely complex question, and one that cannot be systematically answered here. However, a few points related to this issue are worth considering. First, emphasizing "specific projects" in development lending is not necessarily a bad thing—clearly borrowing countries need much of the physical infrastructure that these sorts of loans finance if they are to develop their economies. It may be that program (budget support) lending and more socially-oriented projects are also essential, and indeed all three MDBs have moved in this direction in recent years. But a priori one cannot state categorically that the project-focused lending practices emphasized to reassure bond buyers is inherently less good for development—this would require examining the specific context and development outcomes of each country in question.

Second, the MDB financial model has been spectacularly successful in leveraging very significant amounts of resources and on-lending them very cheaply to developing countries, far cheaper than they could access from other sources. Providing highly concessional loans or grants would be (arguably) more advantageous for the recipient countries, but that is unlikely to be realistic or sustainable over the medium term, in light of the budgetary realities this would imply to donor countries. The experience of the IADB discussed here clearly highlights this. Hence, while dependence on capital market demands may not be ideal, it may also be by far the best available option, absent any major shift in attitude among wealthy countries about transferring resources.

Third, dependence on capital markets does have the benefit—from the point of view of MDB staff—of limiting the political pressure brought to bear by shareholding countries. Since MDBs fund themselves for most recurrent operations, this provides a degree of insulation from the "power of the purse" exercised over agencies (IOs and others) that depend on direct budgetary handouts. This higher degree of autonomy may partly explain why MDBs are uniquely susceptible to principal-agent dynamics, as explored by many researchers.[18] It also explains why periodic capital increases[19] and concessional window replenishments are such contentious episodes for the IADB and World Bank—this is the window of opportunity for wealthy shareholders to exercise direct budgetary control and force through policy changes to their liking.

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[18] This dynamic has interesting parallels to the way New York infrastructure builder extraordinaire Robert Moses amassed and exercised power for so many decades, at times against the wishes of New York City mayors, state governors, and even the U.S. president. As described in Robert Caro's 1974 masterpiece *The Power Broker*, the key to Moses' power was the fact that he had himself written the law creating the Triborough Authority in such a way that it could issue bonds based on its own revenues. Hence Moses depended on no one but Wall Street bond buyers for resources, and he made sure that he kept Wall Street happy. Considering that Moses was at the height of his powers when the World Bank was created, and that the early leaders of the Bank were all Wall Street insiders certainly well aware of Moses' activities, it may well be his power and financial autonomy from politicians was an explicit model for the way they ran the Bank.

[19] All MDBs periodically receive capital increases to expand their operational scope. The capital is not a direct transfer to an MDB's budget, but rather adds to its capital base, from which it generates resources through bond issues (as well as some investment income). The vast majority of capital (over 90%) for the World Bank and IADB is in the form of a guarantee, and hence is not actually transferred at all. The CAF has a much higher share of paid-in capital, because of the nature of its shareholders.

These are the “tail that wags the dog”, in the words of one researcher referring to IDA replenishments (Kapur, 2002: 34).

Despite the three potential upsides to depending on bond markets for financing, there is no question that these organizations were created to promote “development”—a fundamentally political mission—and not act simply as banks. Needless to say, these two priorities do not always sit easily with one another, and the experiences reviewed here suggest that financial considerations usually have the last word. The creation of the concessional lending windows was clearly a recognition of this on the part of shareholder governments, though it may not go far enough, depending on one’s views on how development should be promoted.

Regardless, the MDB financial model as described above here depends on another factor not analyzed here—a steady stream of borrowers for their loans. The rapid rise of numerous middle-income countries—heretofore by far the largest borrowers from MDBs—and the explosive growth of international capital flows may mean this model needs rethinking to face a new set of financial pressures. The recently announced overhaul of World Bank operations by President Jim Yong Kim and ongoing reforms at the IADB may indicate that, once again, MDBs are reshaping themselves in response to external pressure to secure resources.

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